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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	CC Docket No. 96-112
Allocation of Costs Associated	)	
with Local Exchange Carrier	)	
Provision of Video Programming	)	
Services	)	

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BELL ATLANTIC REPLY COMMENTS

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Summary and Introduction

The cable companies continue their repudiated efforts to erect regulatory barricades that would prevent local exchange carrier ("LEC") customers from benefiting from the communications revolution. The Commission and Congress have recognized that consumers are the clear winners when investment in new technology allows companies to make competitive offers of advanced telecommunications and information technologies and services.[1] Cable companies disregard this truth and would have the Commission discourage new joint-use investment by continuing unneeded and burdensome cost allocation rules, and forcing phone companies to over-allocate common costs to unregulated services that would offer much needed competition to the cable companies. The Commission's regulations exempt cable operators regulated under price caps from cost allocation requirements, but cable companies would have the Commission impose such requirements on price cap regulated LECs. The cable industry is so intent on destroying the viability of shared investment by the LECs that even a one hundred percent allocation of common costs to competitive services would not be enough to satisfy them. The cable companies' continued efforts to force these costs onto nascent competitive services is contrary to economic theory and the public good.

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[1] Notice, ¶ 1 (quoting Conference Report, S. Rep. 104-230 at 113 (Feb. 1, 1996)).

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BELL ATLANTIC [2] REPLY COMMENTS

The Commission should reject the cable companies' arguments that it require burdensome cost allocation where there is no legitimate need. and that it arbitrarily mandate an over-allocation of costs to nonregulated services.

I. There is No Need To Impose Cost Allocation Requirements on Companies Regulated Under Pure Price Caps

Price cap regulation breaks the link between prices and costs for regulated services. As economic testimony in this proceeding makes clear, without this linkage "there is no need to perform arbitrary cost allocations . . . because the cost allocation would have no effect on the prices charged for regulated services."[3] Faced with this economic truth, cable companies scramble to

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2 The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington. D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

3 Affidavit of Dr. William E. Taylor, ¶ 10 ("Initial Taylor Affidavit"), attached to Comments of the Southern New England Telephone Company (filed May 31, 1996); ***see also*** Affidavit of J. Gregory Sidak, ¶ 18, attached to Comments of the United States Telephone Association (filed May 31, 1996) ("price caps sever the link that rate-of-return regulation creates between the regulated firm's realized production costs and its allowed earnings").

offer a new justification for continuing burdensome cost allocation requirements. Their arguments offer nothing new and should be rejected.

For example, Cox argues that "[b]y shifting costs from nonregulated to regulated services, a LEC can lower its productivity, resulting in a reduced productivity factor in future years."[4] This is simply not true. One of the benefits of basing regulated prices on an inflation index adjusted by a productivity offset is that these price components are independent from the results of an arbitrary cost allocation process. Current productivity factors are based on studies of historical price movements.[5] Going forward, the Commission has tentatively supported basing the productivity offset on a rolling average of results from a total factor productivity model.[6] Under the LEC industry proposal, the cost inputs to the model would include total company costs, including ***all*** costs of facilities shared with nonregulated services.[7] Arbitrary cost allocations are irrelevant to this calculation, and the resulting productivity offset would be the same regardless of whether any particular costs are allocated to regulated or nonregulated services.

Cable companies also argue that even if pure price caps break any current link between prices and accounting earnings, LECs could, in the future, return to regulation that includes

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4 Comments of Cox Communications, Inc. at 11 (filed May 31, 1996) ("Cox Comments").

5 ***See Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 2176, 2222-24 (1990).

6 ***Price Cap Performance Review for Local Exchange Carriers***, 10 FCC Rcd 8961, 9030 (1995) ("Interim Price Cap Order").

7 ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1, Reply Comments of Bell Atlantic at 6-7 (filed Mar. 1, 1996) ("[I]n the case of the LECs' joint use networks -- which deliver a myriad variety of interstate, intrastate, regulated and unregulated services -- there simply is no economically meaningful way to allocate the joint and common costs of the network . . . and therefore no way to separately measure productivity for these services.").

earnings sharing.[8] In fact, the Commission has already tentatively concluded that it should eliminate a sharing option altogether.[9] Bell Atlantic has consistently supported such elimination.[10] Even if a sharing option remains, however, any company returning to earnings regulation also would be required to return to cost allocations to calculate its regulated earnings. This theoretical possibility offers no basis to require that such allocations be mandated now, when regulated returns are irrelevant to setting prices. In fact, the Commission itself previously reached this very conclusion in the context of its cable rate regulation rules. Where cable companies operate under price caps, they are not subject to cost allocation rules. They become subject to such rules, however, if they make a cost of service showing to justify rates above their price cap.[11]

Moreover, citation to universal service rules do not provide a basis for imposing arbitrary cost allocation requirements here.[12] The issue here is whether cost allocation rules are required as a safeguard against cross-subsidy in the video services market. For pure price cap companies, they are not. The pending universal service proceeding will define which services should be considered universal services, and address the methodology for determining the size and the recipients of a universal service fund. Those issues simply are not relevant to the questions raised in this docket.

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8 ***See, e.g.***, Cox Comments at 11.

9 Interim Price Cap Order at 9049 ("we tentatively conclude that . . . we should move to a system of pure price caps").

10 ***See Price Cap Performance Review for Local Exchange Carriers***, CC Docket No. 94-1: Comments of Bell Atlantic at 7-12 (filed May 9, 1994); Comments of Bell Atlantic on the Fourth Further Notice at 2-7 (filed Jan. 11, 1996).

11 47 C.F.R. § 76.924(a).

12 ***See***, Comments of the Florida Public Service Commission at 2 (filed May 28, 1996).

Contrary to some arguments,[13] the new Telecommunications Act does not require that the Commission continue arbitrary cost allocation rules for companies regulated by pure price caps. Section 254 (k) only requires that the Commission adopt rules where "necessary" to assure that services included in the definition of universal service bear no more than a reasonable share of common costs. Price cap regulation accomplishes this goal by assuring that common costs cannot impact prices. Instead, real price reductions are mandated for regulated services year after year. No cost allocation is required or even relevant. Similarly, Section 254(b)(1) only calls for just, reasonable and affordable rates -- goals that the Commission has already incorporated into its price cap regulations.[14] Indeed, Section 254(b)(2) of the Act seeks provision of "advanced telecommunications and information services" in all regions. Even for non-price cap companies, a cost allocation requirement that discouraged widespread deployment of the technology needed to provide such services would be inconsistent with the Act.[15]

II. Over-Allocation of Costs to Nonregulated Services Will Discourage Investment

For non-price cap companies, the Commission must be wary of curing the shared cost "problem" by mandating an arbitrary fixed allocation factor that would discourage investment in shared-use facilities. This appears to be the goal of cable companies, which abandon their previous

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13 ***See, e.g.***, Comments of the Pennsylvania Office of Consumer Advocate at 6-7 (filed May 30, 1996); Comments of Comcast Cable and Adelphia Communications at 3 (filed May 31, 1996) ("Comcast and Adelphia Comments"); Cox Comments at 2-3.

14 Interim Price Cap Order at 8989.

15 GSA argues that Section 220(a)(2) imposes a Part 64 requirement. In fact, it mandates no specific rules and Section 220(h) specifically allows the Commission to exempt classes of carriers from any rules the Commission does adopt under this section. Moreover, the new Act requires that the Commission forbear from unnecessary regulation. ***See***, Bell Atlantic Comments at 3 (citing 47 U.S.C. § 160) (filed May 31, 1996).

calls for a lower allocation factor, and compete in an unruly bidding contest to propose the most exorbitant allocation requirement with which to saddle the LECs. The winner of this embellishment competition is NCTA, which, along with its expert Dr. Johnson, argues that "even a 100 percent allocation to video would be insufficient to prevent cross-subsidization."[16]

The cable companies reach their excessive allocation factors by limiting regulated costs to the cost of a fictitious digital loop network.[17] According to cable company arguments, this methodology puts the bulk, if not all, of the common costs of new facilities on nonregulated services.[18] Underlying this methodology is an assumption that network modernization provides no direct benefit to regulated service customers. This assumption is wrong. As Bell Atlantic previously demonstrated, limiting regulated customers to a digital loop technology as the cable companies advocate, would deny these customers substantial benefits.[19] Among the benefits customers will enjoy from more advanced technology are superior high speed data transmission, improved reliability, reduced maintenance costs, and enhanced privacy.[20] For companies whose

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16 Comments of the National Cable Television Association at 15 (quoting affidavit of Dr. Leland Johnson) ("NCTA Comments").

17 MCI (p. 6) offers a confused version of this same argument. MCI would have the Commission allocate all costs based on a gross allocator equivalent to "the ratio of stand alone costs to all costs." But when MCI calculates this factor, it uses artificial costs from its Hatfield model and compares these "costs" to revenues.

18 Of course, this assumes that future costs of new facilities will be higher than existing facilities. To the extent that LECs are able to build networks at less than the $700 price targeted by NCTA, the cable companies' logic would indicate that regulated customers would be allocated the same $700 and nonregulated services nothing.

19 Attached as Exhibit 2 is the Supplemental Affidavit of Dr. Charles L. Jackson ("Jackson Affidavit"). This affidavit was filed in response to identical arguments raised by cable companies in the investigation of Bell Atlantic's video dialtone tariff in Dover Township, New Jersey. ***Bell Atlantic Telephone Companies Tariff FCC No. 10***, Transmittal No. 741, Reply of Bell Atlantic to Comments and Oppositions Concerning Direct Case (filed Dec. 20, 1995).

20 Jackson Affidavit, ¶¶ 4-7.

prices are determined by accounting costs, the result of cable's proposed misallocation would be a disincentive to invest in any joint-use network that has costs in excess of cable's arbitrary cut-off. thus denying consumers of both regulated and nonregulated services the benefits of network modernization.[21]

While the Commission's consideration of a 50/50 allocation factor superficially seems more reasonable when compared to cable's extreme allocation proposals, it too suffers from an over allocation to nonregulated services. As Dr. Taylor makes clear in his accompanying affidavit, no allocation of common costs is required to prevent cross subsidy, and any allocation is sufficient to assure that customers of regulated services benefit from the economies of scope of a shared network.[22] As a result, the risk is not under-allocation of costs to regulated services, as some parties suggest. Rather, the risk is that an over-allocation of costs to nonregulated services will stifle the incentive to make an investment in more efficient joint-use facilities in the first place. In that event, all customers -- of both regulated services and nonregulated services -- would be denied the benefit of the most efficient technology choice and would be worse off. Because any allocation of common costs is inherently arbitrary, the Commission must encourage new investment by offering flexible rules that do not require more than the 25-30% allocation to nonregulated services proposed by Bell Atlantic [23]

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21 ***See*** Reply Affidavit of William E. Taylor, ¶¶ 12-18, attached as Exhibit 1 ("Taylor Reply Affidavit").

22 Taylor Reply Affidavit, ¶¶ 5-7.

23 Bell Atlantic Comments at 10.

AT&T purports to offer a "fixed factor for allocating the shared costs of loop plant between regulated and nonregulated activities."[24] In fact, as Dr. Taylor explains, "AT&T's method is merely a diversion to disguise what is nothing more than a fixed allocation of the entire costs of the dual-use network."[25] Rather than allocate common costs, AT&T's proposal would used an arbitrary allocation factor to allocate costs that otherwise could be directly assigned to regulated or nonregulated services. As such, AT&T's proposal "violates both the economic principles of cost causation as well as the FCC's rules."[26]

To avoid undermining investment incentives, the Commission should also reject back-door efforts to over-allocate costs to nonregulated services. For example, while the cable companies advocate allocating the cost of spare fiber to nonregulated services, they offer no evidence that LECs will use that fiber for such services. As already demonstrated, this spare fiber exists because of LECs' provision of regulated services provides real benefit to customers of those services.[27] Indeed, the Commission endorsed the benefits of additional fiber deployment to customers of regulated services when it recognized the continued deployment of such fiber as one accomplishment of the incentives of price cap regulation.[28] It would be arbitrary and

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24 Comments of AT&T Corp. at 4 (filed May 31, 1996).

25 Taylor Reply Affidavit, ¶ 20.

26 Taylor Reply Affidavit, ¶ 22 (citing Notice at ¶¶ 11-12).

27 *See* Declaration of Kenneth D. Hoffman, ¶¶ 6-7 (attached to Bell Atlantic Comments); Reply Affidavit of J. Gregory Sidak, ¶ 21, attached to Reply Comments of United States Telephone Association (filed June 12, 1996) (benefits to regulated customers include "greater network reliability and insurance against longer-period capacity shortages resulting from unforseeable increases in demand").

28 After recognizing that "LEC fiber deployment grew by about 27 percent in 1993," the Commission concluded that "implementation of price caps has not discouraged investment in new facilities or led to diminished investment in network modernization." Interim Price Cap Order at 8988-8989.

incongruous for the Commission now to penalize LECs for such deployment, and assume that regulated customers do not benefit from an improved network.

It would be equally incongruous for the Commission to discourage new investment by mandating an exogenous cost adjustment to account for "reallocation" of costs associated with that investment. Cable companies' arguments in favor of such an adjustment fail to explain how the Commission could "reallocate" costs that were never previously included among regulated costs, or why such an adjustment would not double-count productivity benefits already accounted for in the price cap formula.[29]

III. An Arbitrary Loop Cost Allocation Factor Should Not Apply to Other Costs

Not satisfied with their exorbitant allocation factor for loop costs, cable companies would extend application of this proposed factor to "all common costs addressed in the Notice."[30] Regardless of how the Commission allocates loop costs, this argument makes no sense. The preliminary requirements for any Part 64 allocation is that costs that can be directly assigned or attributed should be directly assigned or attributed.[31] Because switching and inter-office facilities investment can be directly assigned or attributed, there is no justification for using an arbitrary fixed factor. Maintenance and network expenses can be attributed to the proper cost categories based on the relative amounts of total investment -- a cost causative factor. Allocating these expenses only on the basis of an arbitrary loop allocation wrongly assumes that only the

29 *See* Taylor Reply Affidavit, ¶¶ 23-24; Bell Atlantic Comments at 6.

30 Comments of Time Warner Cable at 11 ("Time Warner Comments"); ***see also*** NCTA Comments at 13-14. MCI (pp. 6-7) would similarly allocate all Part 32 costs with a single allocation factor.

31 *See* 47 C.F.R. § 64.901(b)(3).

loop investment causes these expenses. Marketing and overhead expenses can also be assigned using existing Part 64 rules. Allocating these expenses using a fixed factor created for loop costs would rely on an arbitrary and unrelated allocation method when the current rules already provide alternatives that produce reasonable results. There is no legitimate basis for the Commission to mandate such a change.

IV. Any Cost Allocation Requirements Should Apply Equally to Cable Providers

Cable companies suggest that the public policy considerations of their entry into telephony is "very different"[32] from the situation here. In fact, there is no difference. In both situations, the Commission must balance encouraging modernized facilities and new competition with a concern that rate regulated services do not subsidize the incremental cost of new competitive services. To the extent the Commission finds that customers of regulated services are protected by cost allocation requirements, these protections should extend no less when cable companies begin to provide competitive telephone services and charge common costs as a direct add-on to the bills of captive cable television customers. Moreover, the prospect of regulatory parity could also have the beneficial effect of forcing cable companies to offer constructive suggestions for appropriate regulation, rather than distorting Commission rulemakings into a vehicle to stall market competition.

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32 Time Warner Comments at 9, n. 8 (filed May 31, 1996).

Conclusion

The Commission should remove cost allocation burdens for companies under pure price caps, and make the other limited rule changes proposed by Bell Atlantic.

Respectfully submitted,

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June 12, 1996

CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of June, 1996 a copy of the foregoing "Bell Atlantic Reply Comments" was served on the parties on the attached list.

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REPLY AFFIDAVIT OF
WILLIAM E. TAYLOR

CC DOCKET NO. 96-112

PREPARED FOR
BELL ATLANTIC
JUNE 12, 1996

I. INTRODUCTION AND SUMMARY.

1. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. My business address is One Main Street, Cambridge, Massachusetts 02142. My professional credentials are attached to an affidavit I filed in the comment round of this proceeding.[1]

2. I have prepared this affidavit at the request of Bell Atlantic to respond to economic issues raised by parties filing comments in the Federal Communications Commission's (FCC's) CC Docket No. 96-112,[2] particularly the comments of National Cable Television Association (NCTA) and its economist, Leland Johnson, AT&T and Cox Communications. In my view, (i) under pure price cap regulation, cost allocation does not affect price levels and is unnecessary, (ii) the existing safeguards—including Part 64 cost allocation procedures—are sufficient to ensure that local exchange carriers (LECs) not regulated under pure price caps do not engage in cross-subsidization, and (iii) common cost allocations, which are inherently arbitrary, must not be unreasonable.

II. PRICE CAPS ELIMINATE COST ALLOCATION CONCERNS FOR REGULATED SERVICES.

3. Under price cap regulation, prices of all LEC interstate services are constrained by the price cap index (PCI) for each basket and by the band limitations within the baskets. Each year, the allowed changes in prices for regulated services are determined by a formula that includes inflation, offset by a fixed productivity target. The accounting costs of such services are not considered in any of the mechanisms that control the price caps, and, therefore, do not have any effect on the prices charged for LEC interstate services. Hence, the accounting costs of these

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[1] Affidavit of William E. Taylor, attached to the Comments of SNET, May 31, 1996.

[2] Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, Notice of Proposed Rulemaking, CC Docket No. 96-112 (May 10, 1996). (LEC Video Cost Allocation NPRM)

services are not relevant to the prices approved by the FCC. Furthermore, the interstate services of nearly all of the price cap regulated LECs are subject to pure price cap regulation: i.e., price cap regulation with no requirement to share accounting earnings.[3] Such regulation prevents regulated companies from offsetting price cuts or cost increases in competitive markets[4] with price increases for regulated services under any circumstances. There is thus no need to perform arbitrary cost allocations for those firms under pure price cap regulation because the cost allocations have no effect on the prices charged for regulated services. Moreover, contrary to AT&T's and other competitors' recommendation to continue cost allocation procedures for all price cap regulated LECs,[5] cost allocation is not a meaningful exercise under any form of price caps. The link between pricing below cost today—incurring losses with certainty—and possibly reducing the productivity offset or a sharing obligation in the future is far too tenuous to affect the firm's incentive to engage in cross-subsidization.

4. In summary, for price-cap regulated LECs, maximum prices for regulated services are determined by formula and cannot be increased to offset reductions in the prices of non-regulated services. The prices of nonregulated services are determined by market conditions and are subject to an incremental cost price floor. The prices of both regulated and nonregulated services are thus set without regard to allocations of common costs between the service categories. Even for those few LECs whose services are not regulated by price caps, cost allocation is not necessary to prevent cross-subsidies.

[3] LEC Video Cost Allocation NPRM at ¶ 61.

[4] Prices for nonregulated services (in competitive markets) are set to equal or exceed incremental costs, depending on the market conditions. Therefore, fully distributed cost methodology and the allocation of common costs are irrelevant in the setting of prices in competitive markets

[5] Comments of AT&T Corp., May 31, 1996, at 11.

III. FOR EARNINGS-REGULATED LECs, COST ALLOCATION POSES GREATER RISKS THAN CROSS-SUBSIDIZATION.

A. There is minimal risk from cross-subsidy.

5. Allegations of potential cross-subsidization are inevitably raised by competitors of nonregulated services whenever a regulated firm provides both regulated and nonregulated services.[6] The theory of cross-subsidization is understood by many economists[7] and accepted as the analytic background for public policy decisions of the type facing the Commission in this proceeding, and three components of that theory have particular bearing on this case:

- a service receives a subsidy if the incremental revenue from the service fails to cover the *incremental* costs of supplying the service.
- incremental costs for a firm are measured by the minimum change in costs required to expand capacity to serve an additional increment of demand (which may be as large as an entire service).
- assignments of costs to services on other than a cost-causative basis have no role in determining whether a service receives a subsidy.

Thus only forward-looking incremental costs matter for cross-subsidy protection,[8] those costs must be measured correctly, and assignment of fixed costs—costs that do not vary with the supply of the nonregulated service—to the nonregulated service has no bearing on whether that service receives a subsidy or the regulated services provide a subsidy.

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[6] See, e.g., Comments of NCTA, May 31, 1996, at 3-4.

[7] These concepts are well-established in economics, though the nomenclature sometimes varies. See, e.g., W.J. Baumol, "Minimum and Maximum Pricing Principles for Residual Regulation," *Eastern Economic Journal* V(1-2), January/April 1979, at 235-248. W.J. Baumol and G. Sidak, *Toward Competition in Local Telephony*, Cambridge: The MIT Press, (1994) at 55-59. G.R. Faulhaber, "Cross-Subsidization: Pricing in Public Enterprises," *American Economic Review* 65(5), December 1975, at 966-977.

[8] The purpose of this proceeding—assurance that cross-subsidies do not exist—is different from the setting of interconnection prices in CC Docket No. 96-98. Incremental costs are necessary to test for the presence of a subsidy and are used as the price floor in setting prices, but, by themselves, they do not determine the price at which services should be set. Multiproduct firms with economies of scale and scope must price services flexibly above incremental cost in order to cover their total costs while facing competition.

6. While there appears to be universal agreement that the allocation of common costs (that do not vary with the supply of a service) is an inherently arbitrary process,[9] there are cost allocators that, though arbitrary, are reasonable. Unregulated multiproduct firms in competitive markets take market prices as given, and yet, in equilibrium, must necessarily recover their total costs, including volume or service insensitive costs, from prices which equal or exceed their incremental costs in each market. Those prices can be thought of as "reasonable" allocators of cost and are reasonable because the "allocators" are determined by competitive processes in different markets.

7. It appears that the NCTA is confused about the arbitrary nature of the allocation of common costs[10] and the role cost-causation plays in determining whether services are receiving cross-subsidies. For example, NCTA states

> [b]ecause the allocation of common costs is an inevitably somewhat arbitrary process, it is not possible to explicitly base the allocation decision on cost causation. The principle of a cost-causative allocation process provides an efficient outcome because -- assuming prices track costs -- customers will pay for the costs of the services they receive. Further, as the Commission recognized in the Notice, following principles of cost causation minimizes cross-subsidies.[11]

Allocation of <u>any</u> portion of common costs is arbitrary, and it makes no sense to claim that an allocator is only "somewhat" arbitrary. There is no such thing as "a cost-causative allocation process;" incremental costs are directly assigned on a cost causative basis and the remaining costs may be assigned on a reasonable but arbitrary basis. Assigning incremental costs to services based on cost causation "minimizes cross-subsidies;" allocation of remaining common costs has nothing to do with cross-subsidies.

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[9] LEC Video Cost Allocation NPRM at ¶ 23.

[10] Here NCTA apparently uses "common costs" to mean fixed (i.e. volume or service insensitive) costs that are shared by all services the firm supplies.

[11] NCTA Comments at 10 (footnote omitted).

B. There is significant risk from overallocating fixed costs.

8. If cost allocations must be established for accounting purposes, the FCC would best serve the public interest if those allocations—though arbitrary—were reasonable. Once the incremental costs of the new broadband network are assigned to regulated and nonregulated services based on cost causation, allocation of remaining costs runs the risk of distorting choices made by consumers and investors and frustrating market forces in either regulated or nonregulated services. The damage caused by an overallocation of common costs to any service includes not only the loss of efficiencies (both technical and allocative) but also the lost or reduced investments that the regulated firm would otherwise have undertaken.

9. The entry of LECs in the video programming and distribution markets would be delayed or significantly curtailed if the FCC were to follow the advice of the LECs' competitors, the cable television companies. Several cable television companies support the use of national allocation factors for common costs, even if an overallocation to video services occurs.[12] No economic justification, of course, is or can be offered for such a proposal.

10. In addition, the fallacy that economies of scope are benefits that should be shared between customers of the relevant services appears in several other comments.[13] This reasoning reflects bad economics and would result in poor public policy. Sharing the benefits of economies of scope is precisely what efficient economic markets do <u>not</u> do. Multiproduct firms enjoy different economies of scale and scope as they combine different products and services (and different amounts of those products and services) in their mix of outputs, and competition among such firms is driven by the cost savings in each market that the firms are able to achieve. An artificial requirement that prevents any firm from pricing services down to the minimum level established by the cross-subsidy test in a particular market is inherently anticompetitive, and the competitive process in a market tainted by such requirements would

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[12] See, e.g., NCTA Comments at 11.

[13] See, e.g., Comments of the Pennsylvania Office of Consumer Advocate (at 6), MCI Telecommunications Corporation (at 9), AT&T Corp. (at 3), and Cox Communications (at 8-9).

not serve the public or provide the benefits of competition that the FCC and the Telecommunications Act of 1996 seek to obtain.

C. To minimize risk, the allocator of common costs must be flexible to differ by company, by technology and over time.

11. While a fixed allocator may be the most expedient way to assign fixed common costs between regulated and nonregulated services, the particular allocator must be sufficiently flexible so as not to foreclose opportunities to competitive entrants in the video programming market—the LECs. What is a reasonable allocator for one firm or one technology may be unreasonable for another, so that to avoid distorting market outcomes, fixed allocators must be able to differ across firms, across technologies and over time. The real issue at stake when common costs are allocated to nonregulated services—particularly by price-cap regulated LECs—is competitiveness, not cross-subsidization. Each LEC should have the flexibility to set the allocation factor based on circumstances specific to its deployment of the joint-use network and the nonregulated services it will provide.

IV. SPECIFIC PROPOSALS THAT DO NOT RECOGNIZE THESE PRINCIPLES DO NOT OFFER ECONOMICALLY REASONABLE POLICY ALTERNATIVES.

A. The stand alone cost of telephony service is not the economically correct measure of the cost of any service in the real world.

12. NCTA's characterization of a stand alone cost test as "an important benchmark"[14] and Dr. Johnson's employment[15] of such a methodology are flawed on at least two accounts. First, and fundamentally, it is impossible at this time to know which services—regulated and nonregulated—will be offered over the joint-use network in the future, and it would be folly to establish cost allocation procedures on the basis of forecasts of such uncertain events. The new integrated broadband network will simultaneously:

[14] NCTA Comments at 9.

[15] "Allocating Common Costs to Avoid Cross-Subsidy and Enable the Sharing of Benefits," by Leland L. Johnson, Attachment 1 to NCTA's Comments. (Johnson)

- support existing traditional regulated telephone services, reducing operating and maintenance costs and improving service quality.
- provide new—possibly regulated—high-speed data services such as internet access, medical imaging and distance learning, and
- provide new nonregulated services including video programming and distribution.

The totality of services that will ultimately be provided over the new network is unknown and unknowable today, as is the cost of those services (incremental to those of the integrated network), their revenues and their classification as regulated or nonregulated. One cannot detect or deter cross-subsidization of a nonregulated service by checking that the costs assigned to regulated services in the new network are smaller than in a hypothetical stand alone network designed solely for the regulated services in question. The better regulatory strategy is the one followed by the FCC: to isolate the prices of regulated services from accounting costs, as price caps do, so that the prices paid by customers of regulated services are unaffected by the commercial success or failure of the integrated network and, in particular, by how the costs of that network are assigned to services.

13. Although the cable companies proposed this stand alone cost test in their comments during a video dialtone proceeding,[16] the proposal was correctly rejected as a matter of principle by the Common Carrier Bureau in its Dover Order.[17] The FCC recognized the fact that the telephone network is evolving to provide many new services and that not all of the shared costs in excess of stand alone costs of a narrowband telephone network are caused by the decision to supply the broadband service:

> because the telephone network is constantly being upgraded, the question is not simply whether or not all costs above the existing costs of telephony should be assigned to video dialtone service. Rather, the issue is how much of the costs are incremental to the cost of providing an expanding array of services over the

[16] NCTA, Petition to Reject, or in the Alternative, to Suspend and Investigate Bell Atlantic's Video Dialtone Tariff for the Dover System, February 21, 1995, at 16-17

[17] Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 10 Rates, Terms, and Regulations for Video Dialtone Service in Dover Township, Transmittal Nos. 741 786, CC Docket No. 95-145, Order, (Dover Order), Released June 9, 1995.

> telephone network. In other words, it is incorrect to view all changes to the present telephone system as incremental to video dialtone service because a portion of those changes would have been made to the system as part of the normal upgrade, with or without the decision to provide video dialtone. (Dover Order at ¶ 27).

14. The assertion that sufficient costs must be allocated to nonregulated services so that the remaining costs are less than the cost of a stand alone network that supplies regulated services is incorrect. In competitive, unregulated markets, prices of individual products or services can rise when new technology or tastes change and the mix of new products or services changes. The classic example is provided by A.E. Kahn and W.B. Shew:

> Competitive markets have the virtue of offering consumers a variety of price and quality options, but that spectrum of offerings is not unlimited. It is not economically feasible to provide all conceivable packages. For example, there may be some automobile buyers who would prefer to buy cars without bumpers or fenders, at a correspondingly reduced price; but in view of the economies of producing standardized models, it probably would actually be more costly to satisfy their idiosyncratic desires than to supply them with the models preferred by the great majority of customers. In that event, they have no legitimate complaint about not having available to them, at a lower price, a stripped-down version that would have to be custom-made.[18]

In the current example, taking all benefits and costs of narrowband and integrated networks into account, if the integrated network provides the largest difference between benefits and costs for all subscribers taken together, that network should be built, and subscribers who use only narrowband services should nonetheless pay at least the incremental cost they impose on the integrated network, even if that price exceeds their current price.

15. In contrast, Dr. Johnson would effectively place a cost-allocation ceiling on regulated services based on current consumer choice and technology. The resultant overallocation of costs to nonregulated services would discourage network investment, thus harming customers of regulated and nonregulated services. Such an allocation is not the way the prices would be

[18] Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation*, Vol. 4, Number 2, Spring 1987, at 230-231